V
FINANCIAL SECTOR

No significant changes took place in the second quarter in Estonian financial sector (see Figure 5.1). Assets of banks and leasing companies increased whereas the growth rate remained below the year-ago period. Banks' loan portfolio kept growing, especially lending to financial institutions. Slightly under a billion kroons of which reached the local leasing market, less than in the second and fourth quarter of 2000.

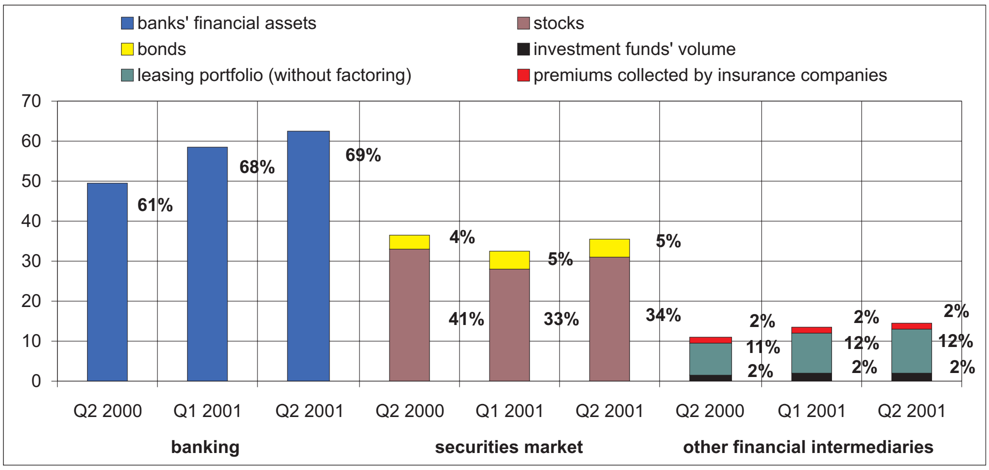

Figure 5.1. Estonian financial intermediaries (EEK billion and % of GDP)

On banks' liabilities side private deposits continued growing whereas business undertakings are increasingly using services of money market funds. The growth in the volume of money market and interest rate funds, started in the first quarter, was sustained – their assets increased by a billion kroons in the first half-year. The share of time deposits keeps growing in the deposit structure, indicating continued financial deepening.

In the second quarter the securities market was slightly more active and prices went up whereas in summer international markets pushed Estonian stock prices downwards. The bond market maintained high volume of capitalization and new issues; local issuers became more active. The volume of insurance premiums was contained on the level of previous periods.

Banking

Banks' Assets and Their Quality

Banks' loan portfolio reached 42% in the second quarter against the GDP of the last four quarters. The share of lending to financial institutions is increasing and that of corporate lending decreases.

The highest growth was in lending to private individuals, especially in real estate lending, reaching five billion kroons by the end of the second quarter. The volume of consumption loans went up in summer months, as well. **Also lending to all sectors of economy moved upwards, excluding energy and construction** (see Figure 5.2). Rapid growth in lending to real estate intermediation became evident again.

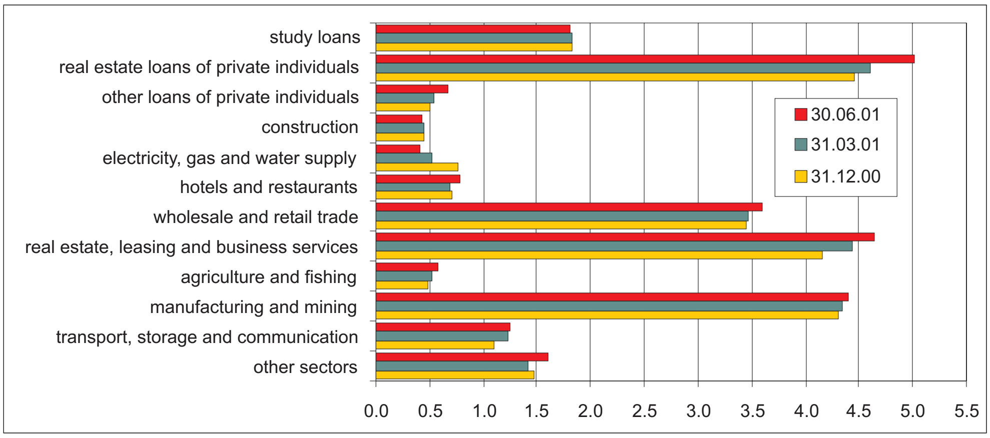

Figure 5.2. Banks' loan portfolio by sectors of economy (EEK billion)

Parallel to a volume increase in private real estate borrowing, the share of loans secured by mortgage continues growing, too. Contemporaneously, the use of securities and buildings as collateral has decreased. By maturity the volume of loans with 6-12month and over five years of maturity has grown smoothly over the last years. Loans with over 10 years of maturity are continuously responsible for 17% of the loan portfolio.

While due to the reserve requirement reform at the beginning of the year claims to the central bank decreased in the first quarter, the level stabilised in the second quarter. **In the third quarter the claims to the central bank should decrease once again as beginning from 1 July credit institutions can meet a half instead of a quarter of the reserve requirement in liquid foreign assets.** In order to rapidly resort to this opportunity, banks increased the stock of foreign bonds in the securities portfolio to 2.9 billion kroons by the end of June (see Figure 5.3). This was partially done at the expense of the trading portfolio that shrank by 400 million kroons.

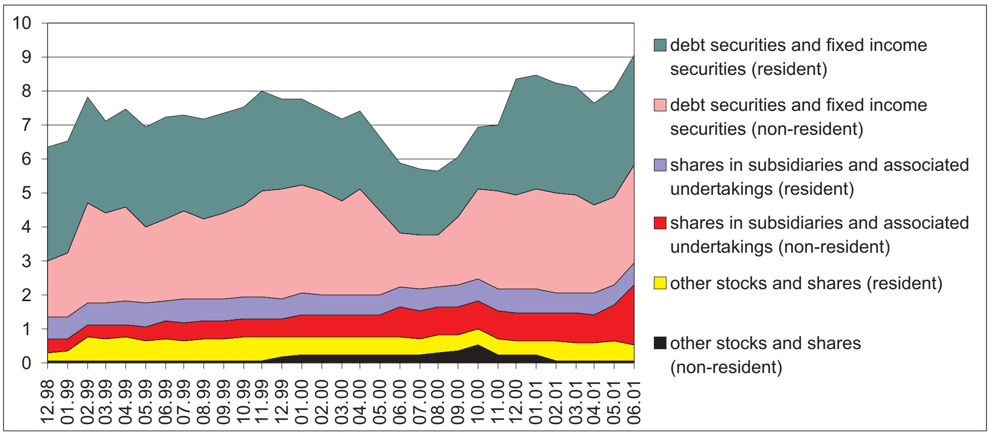

Figure 5.3. Bank's securities portfolio (EEK billion)

Besides the growth in foreign bond stock, the volume of affiliate shares increased also as the result of the acquisition of the Lithuanian Savings Bank (*Lietuvos Taupomasis Bankas*) by

Hansapank. As a result, the volume of equity participation in the banks' total assets reached nearly 2.4 billion kroons. By maturity it should be noted that the volume of domestic bonds with maturity over five years reached 1.45 billion kroons by the end of June.

Although the absolute volume of overdue loans did not change in the second quarter, their share shrank due to the growth of the loan portfolio (see Figure 5.4). By sectors the share of overdue loans increased in industry, transport and logistics as well as in energy (ie in the open sector). However, it is too early to draw significant conclusions as, for example, the majority of overdue loans in industry is overdue less than 30 days. **Despite of the rapidly growing lending to individuals, the share of overdue loans to this sector has decreased.**

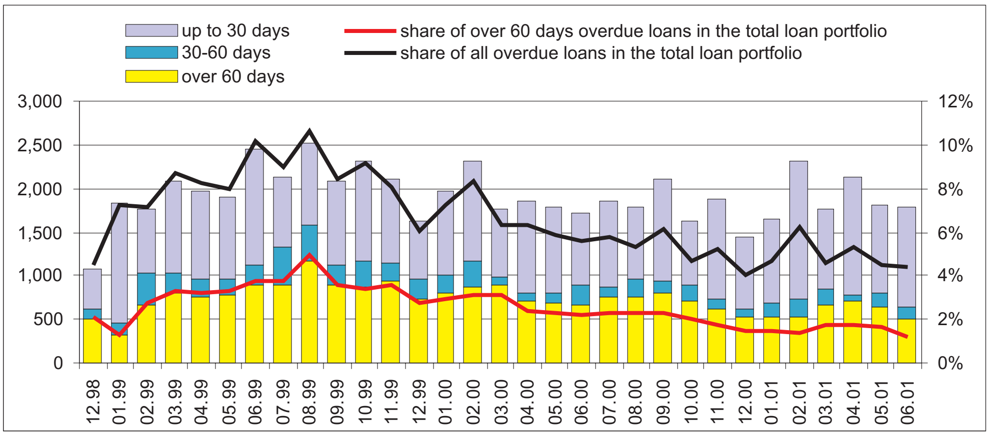

Figure 5.4. Volume of overdue loans (EEK m, the left scale) and their share (the right scale) in banks' loan portfolio

Liabilities

Since the end of 2000, declining resource prices have supported the growth in banks' financial leverage. **Regardless of declining deposit interest rates, private deposits' volume displays stable growth, being responsible for nearly a third of banks' liabilities** (see Figure 5.5). At the same time, dropping interest rates have inhibited the growth in corporate depositing. They are more interest sensitive as customers and have channelled part of their resources to money market funds.

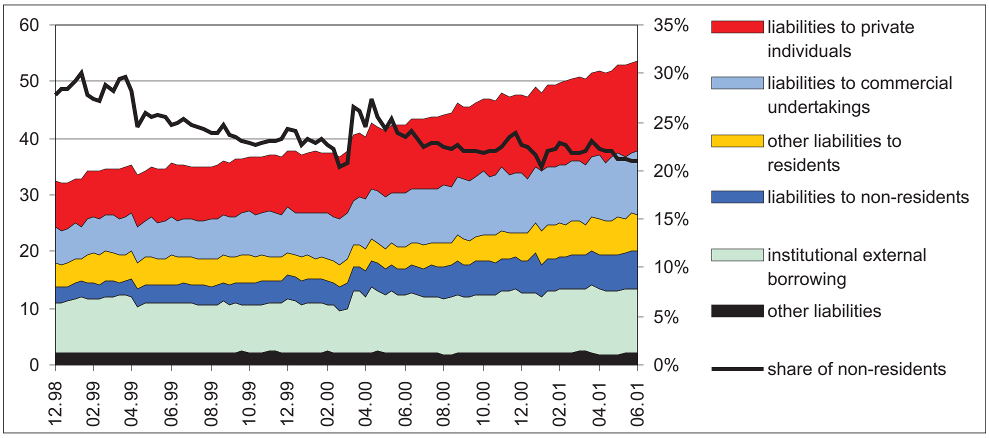

Figure 5.5. Banks' external liabilities (EEK billion, the left scale) and share of non-residents (%, the right scale)

By maturity 3month time deposits have had the most pronounced growth whereas an upward trend is characteristic of all volumes of deposits with maturity less than a year. The increasing share of deposits in the balance brings along a decline in the share of bonds issued and in borrowing (ie institutional external borrowing). This is primarily due to lower deposits compared to external borrowing.

Return on Equity

Due to simultaneous contraction in profit margin and assets utilization, return on equity has dropped as well (see Table 5.1). This reveals that banks have not coped with efficient cost management under shrinking income. **Both interest and non-interest expenses have decreased more slowly than interest revenues.** Non-interest expense decreased more solely due to the growing administrative costs.

Table 5.1. Banks' profitability indicators

	Q3 1998	Q4 1998	Q1 1999	Q2 1999	Q3 1999	Q4 1999	Q1 2000	Q2 2000	Q3 2000	Q4 2000	Q1 2001	Q2 2001
Equity multiplier	8.66	7.08	6.25	6.35	6.31	6.37	6.27	7.01	7.34	7.72	7.85	7.91
Return on equity	-4.53%	-9.42%	2.04%	2.38%	2.13%	2.63%	3.24%	2.55%	2.45%	0.19%	4.08%	2.92%
Return on assets	-0.52%	-1.33%	0.33%	0.37%	0.34%	0.41%	0.52%	0.36%	0.33%	0.02%	0.52%	0.37%
Profit assets	-0.16	-0.38	0.10	0.12	0.12	0.14	0.19	0.14	0.12	0.01	0.18	0.14
Assets utilization	3.26%	3.51%	3.13%	3.24%	2.79%	2.88%	2.75%	2.67%	2.71%	2.99%	2.94%	2.62%

Assets utilization, ie banks' income-earning capacity contracted due to a relative decrease both in interest rate income and non-interest rate income. The average interest rate income of deposits and loans sustained a fall for the second consecutive quarter, displaying increasing channelling of loans to leasing and reflecting an interest rate drop in previous periods.

The ratio of non-interest income to assets decreased despite the flying growth in service charges. Non-interest rate income has been subject to negative impact arising from inhibited income from financial investments and change in the value of assets and liabilities.

The sustained decline in net interest margin and spread came to a halt. The spread has been moving upwards because of the relatively faster contraction of interest expense against interest rate income. Apart from a faster drop in interest expense, net interest margin gained also from slower growth of the revenue base.

Securities Market

Stock Market

The capitalization of the stock market started to grow in April, reaching 32.8 billion kroons by end-May, but due to the falling tendency in the technology sector fell again to 31.0 billion kroons (see Figure 5.6). The volume of the stock market grew through the initial registration of a large number of shares[1], disclosure of last year's financial results and, first and

[1] The large number of shares in initial registration was probably due to the fact that the Estonian Central Depository for Securities would conduct initial registration of shares free of charge until the end of the year.

foremost, subsequent dividend payment. Prior to establishing a dividend-entitled investor list, residents and non-residents conducted active purchase transactions in order to avoid income tax, increasing the turnover of the stock market and pushing prices upwards.

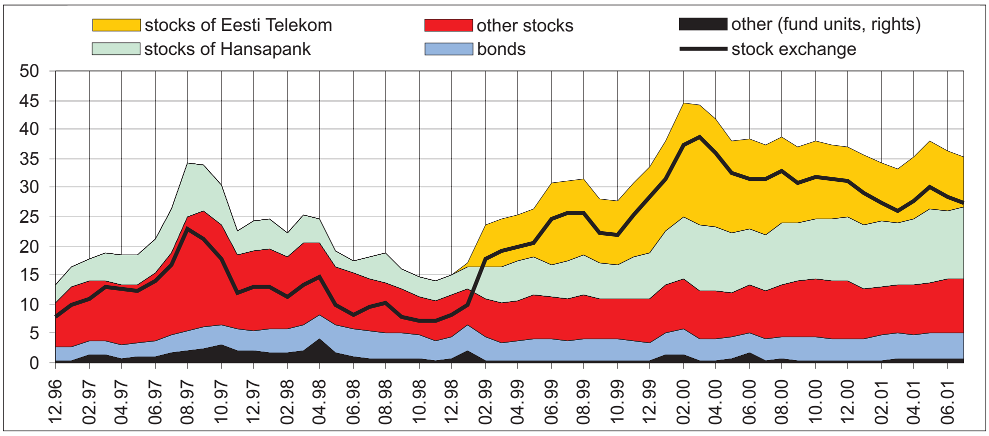

Figure 5.6. Securities market capitalization (EEK billion)

The capitalization of Tallinn Stock Exchange was 28.3 billion kroons. The above developments sent the index TALSE upward during April-May by 18.5% whereas in mid-June the latter started slowly to decrease and was by end-June 4.2% below end-May, reaching 141.6 points (see Figure 5.7). The price of stocks in the services (+20%) and banking sectors (+16%) increased most. In June a significant setback in the price of services sector stocks took place. In the second quarter the price of industrial enterprises' stocks did not actually change due to the lack of interest and activity.

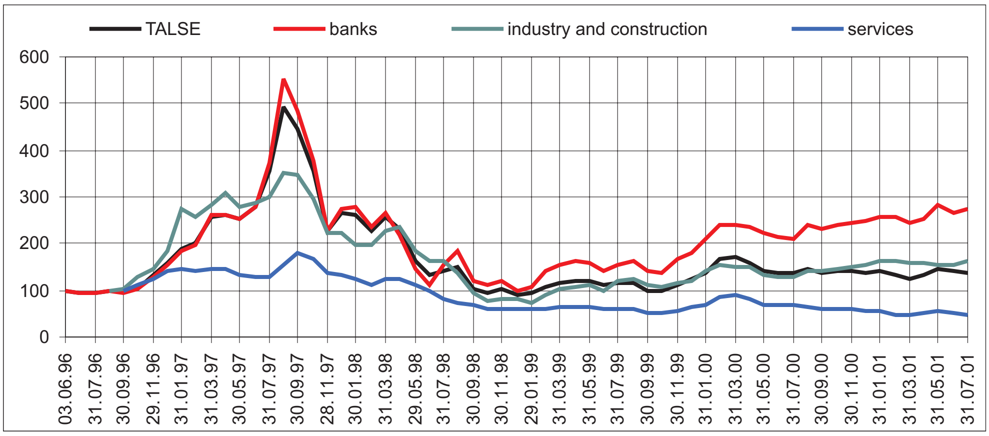

Figure 5.7. Indices of stocks traded on the Tallinn Stock Exchange by sectors of economy and TALSE (points, 3 June 1996 = 100)

Bond Market

The bond market maintained its large volume in the second quarter. **Beginning from end-February market capitalization has reached an average of 4.2 billion kroons, exceeding 4.5 billion kroons in June. The volume of new issues kept growing for the second consecutive quarter and exceeded 1.56 billion kroons in the second quarter.** Maturities are still short (see Figure 5.8).

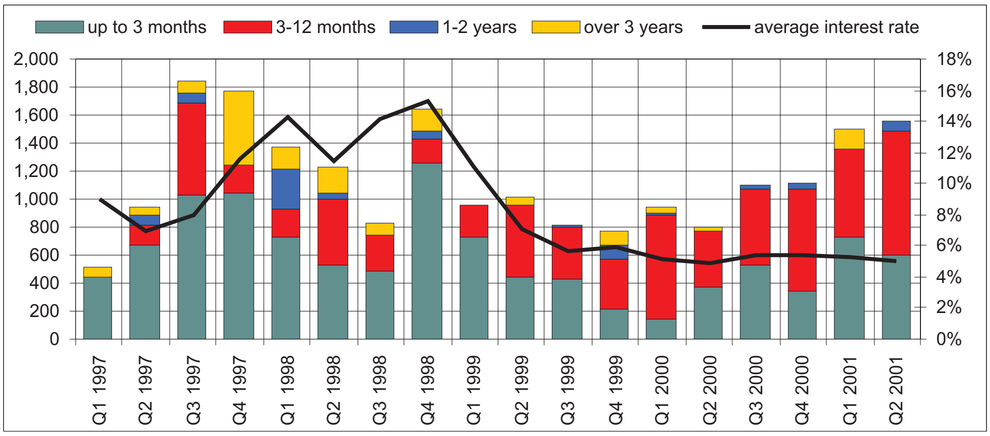

Figure 5.8. Volume of bonds issued in a quarter by maturity (EEK m, the left scale) and average interest rate of kroon bonds (the right scale)

The share of local undertakings among issuers increased and that of non-resident credit institutions decreased. Increased interest among local issuers can be associated with a slight decline in the interest level. At the end of 2000 the average interest rate was around 5.3%, while this year interest rates started to decline in the first quarter and reached 5.1% by the end of the second quarter.

Other Financial Intermediaries

Insurance

Also in the second quarter non-life insurance companies collected premiums slightly less than in the previous quarter, 342 million kroons that is still quite a good result against the year-ago period (see Figure 5.9). Among types of insurance **private individuals' motor vehicle insurance** was the most successful whereas the share of compulsory motor TPL insurance keeps shrinking in gross premiums. The share of insurance of private individuals' property is also large, reflecting continuous activity in the housing market and growth in real estate borrowing.

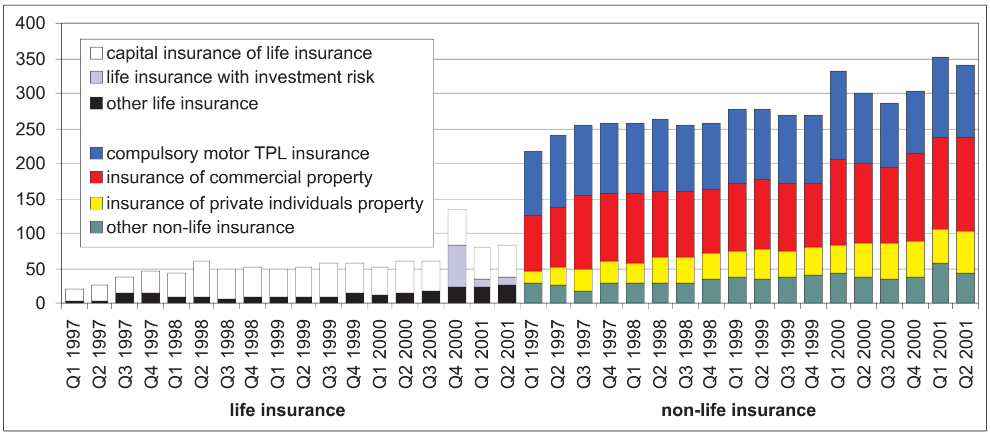

Figure 5.9. Gross premiums collected by insurance companies (EEK m)

In the third quarter tariffs of the compulsory motor TPL insurance are anticipated to increase, being conducive to premium growth as well. The new Motor Third Party Liability Insurance Act that entered into force in June provides for wider insurance cover, increasing the compensation paid by insurance companies and inducing growth in the revenue base. About half of the non-life insurance companies have already raised motor TPL insurance tariffs by 6-8%.

Life insurance companies gathered about 83 million kroons of premiums, slightly more than in the first quarter, yielding an adjusted amount of 80 million kroons. The share of unit-linked life insurance decreased in the first half-year, having gained significantly in end-2000. Endowment restored its previous share. The share of pension insurance premiums in gross premiums was over 20% in the second quarter.

Leasing

The leasing portfolio reached 10.7 billion kroons by the end of the second quarter, totalling together with factoring 11.9 billion kroons. The volume of the consolidated portfolio increased by about 1.3 billion kroons over the quarter (see Figure 5.10). In the structure of the leasing portfolio, sale by instalments is continuously gaining in share. This is popular due to new financial products launched in 2000 and the reviving of real estate market. By the end of the second quarter sale by instalments was responsible for 27% of the leasing portfolio and sustains the growth from shrinking capital lease (that comprised 50% of the portfolio). The share of operating lease and consumer factoring has somewhat grown.

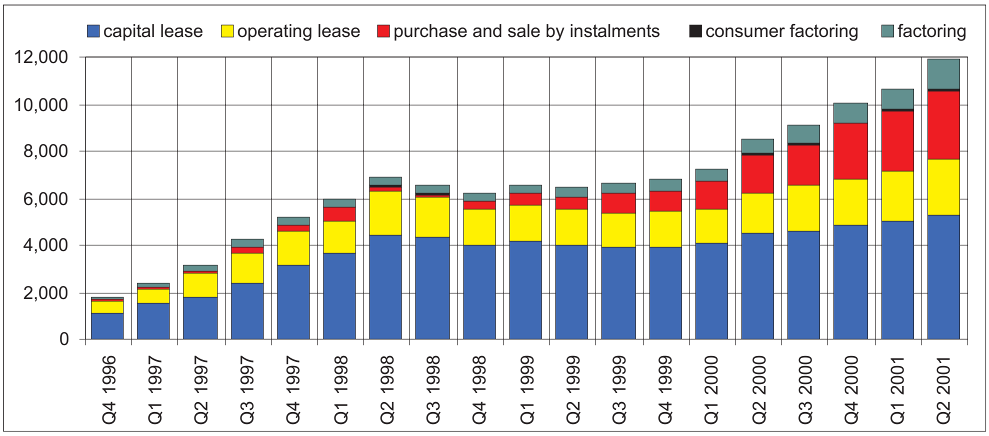

Figure 5.10. Volume and structure of leasing companies' portfolios (EEK billion)

Investment funds

The 600-million-kroon growth in the volume of investment funds at the beginning of the year continued in the first two months of the second quarter as well: another 400 million kroons were added in April and May and the gross volume of funds exceeded 2.4 billion kroons. Mainly money market funds grew but also interest rate funds. In June the volume of money market funds shrank by 250 million kroons whereas interest rate funds remained unchanged (see Figure 5.11).

The structure of investment fund assets is relatively constant. Rapid growth in volume has brought along larger amounts on bank accounts that are probably waiting to be placed into stocks and bonds. **A slight drop in the average return of money market and interest rate funds, remaining below 4 and 5%, respectively, accompanied rapidly growing asset volume.** In early-June another bank-owned money market fund was set up and, apart from that, in early August another pension fund was launched.

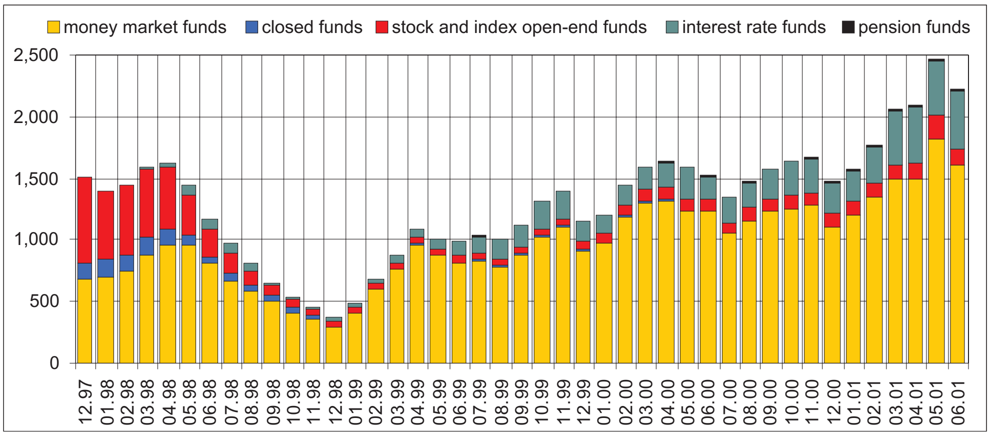

Figure 5.11. Leasing portfolio by sectors of economy (EEK billion)

Payment System

The sustainable high economic growth found an outlet in more active use of the financial structure in the second quarter. **The number of payments has grown this year by 45% against the second quarter of 2000, getting close to six million transactions a month** (see Figure 5.12). **The turnover of transactions increased, meanwhile, by about 13%, remaining slightly below the first quarter. The turnover of domestic payments grew most – by close to 38%.**

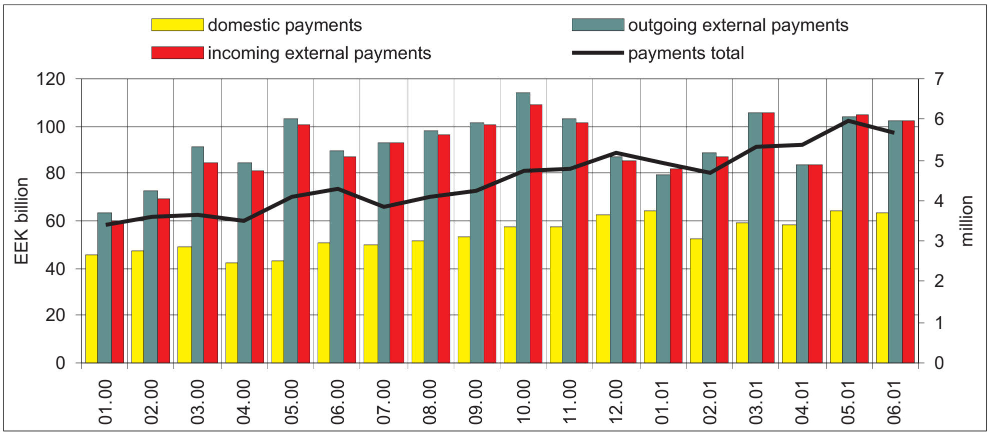

Figure 5.12. Turnover of payments by types (EEK billion, the left scale) and total number of payments (million, the right scale)

The data for payments has been changed as of January 1, 2000 due to the fact that Hansapank specified queries for the compilation of the payments report and added the data for payments related to derivatives.

The share of conventional paper-based payment orders keeps decreasing – from 10.1% in the second quarter of 2000 to 5.4% in the same period this year. Out of electronic payment modes the share of telebanking and telephone banking has been diminishing. More and more Internet banking, card payments and direct debit are being used (see Figure 5.13). The share of standing orders remained on a year-ago level – 1.6% – in the second quarter.

The number of bankcards has increased by about 9% over the year, reaching 925 000 of which 92% were debit cards and 8% were credit cards. **The growth in the number of credit cards that started in the second half of 2000 was sustained in the second quarter,**

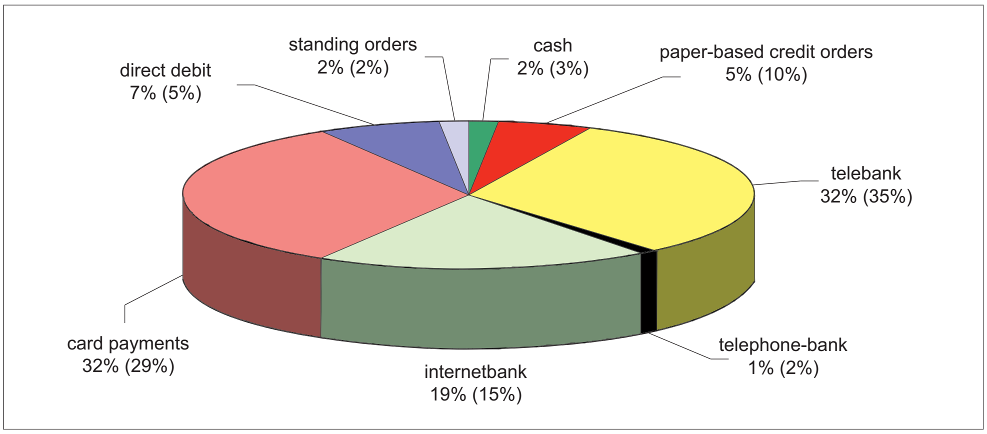

Figure 5.13. Structure of payment instruments in the 2nd quarter of 2001 (in brackets 2nd quarter of 2000)

increasing more than threefold over the year (from 25,500 to 77,900). This development is the result of new non-cash payment instruments launched last year accompanied by successful marketing campaigns.

The general trend in banking lies in closing down smaller and less-effective branches, increasing simultaneously the number of ATMs. 25 ATMs have been installed during the year, totalling 640 by the end of the second quarter of 2001. Tougher competition and increasing awareness have flung the number of points of sale from 3,626 to 4,768 over the year.